

To: Distribution

From: Michael G. Stoltz, Carl R. Ceppert, Chicago

Date: February 5, 1993

Subject: Ameritech Services, Inc. - 1992 Part 64 Compliance

In connection with our audit of the financial statements of Ameritech Services, Inc. (ASI) for the year ended December 31, 1992, we have also reviewed the procedures with respect to the allocation of ASI's cost of providing services among the Ameritech Operating Companies (AOCs). Our audit was made in accordance with generally accepted auditing standards and included the following procedures with respect to these cost allocations:

1. We reviewed the procedures relating to the accumulation, summarization and billing of the cost of providing services as determined in accordance with the November 30, 1983 Stockholders' Agreement, as amended (the Agreement), and the Federal Communications Commission (FCC) Part 32 (Section 32.27) and Part 64 (Section 64.901) Rules and Regulations.
2. We reviewed and tested the internal controls over the procurement, information technology and professional services billing and cost allocation procedures.

As a result of the foregoing procedures:

1. We have found no material weaknesses in ASI's procedures relating to the accumulation, summarization, allocation and billing of the cost of providing services to the AOCs. These cost allocation procedures comply, in all material respects, with the FCC's affiliate transaction rules contained in Part 32 (Section 32.27) and Part 64 (Section 64.901) of the FCC's Rules.
2. Nothing came to our attention which indicated that the costs of providing such services allocated to each of the AOCs was not computed in accordance with the Agreement or that any material adjustments of the amounts allocated to each of the AOCs are pending or contemplated.

Date: November 15, 1994

Subject: Ameritech Services, Inc. - 1992 Part 64 Compliance

Should there be any questions regarding ASI billings, please contact us.

Michael G. Stoltz

Carl R. Geppert

KOB

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Exhibit 2

ILLINOIS COMMERCE COMMISSION

**Focused Management Audit
of the Affiliated Transactions of
Illinois Bell Telephone Company**

June 1993

SECTION IV

AMERITECH SERVICES, INC.

PGS. 173 - 228

PROPRIETARY AND CONFIDENTIAL INFORMATION (*) HAS BEEN DELETED
FROM THIS REPORT. PARTIES WISHING TO OBTAIN A COPY OF THIS
REPORT CONTAINING THE CONFIDENTIAL INFORMATION SHOULD
CONTACT ILLINOIS BELL TELEPHONE COMPANY.**

IV. AMERITECH SERVICES, INC.

This chapter assesses billings from Ameritech Services, Inc. (ASI) to Illinois Bell Telephone Company (IBT). The test year review period extends from September 1, 1991 through August 31, 1992 (as specified in IBT's alternative regulatory framework filing).

IBT's affiliate relationships, including its relationships with ASI, are governed by the Illinois Public Utilities Act and related Illinois Commerce Commission (ICC) rules which require that IBT receive ICC approval for affiliate agreements and for transactions in excess of 5% of non-competitive revenues, or one million dollars, whichever is less. Additionally, Federal Communications Commission (FCC) Part 64 and ICC 83 Illinois Administrative Code Part 711 rules specify the basis upon which transactions between IBT and nonregulated affiliates must be handled.⁹¹

A. RELATIONSHIP ASSESSMENT, BACKGROUND, AND PERSPECTIVE

This section provides background and perspective information and data for ASI to IBT affiliate relationships and transactions, and delivers a summary evaluation of the relationships.

SERVICE IDENTIFICATION AND FUNCTIONAL MATRIX DEVELOPMENT

S-WS-40001 *Determine what services ASI provides to IBT and whether the services are necessary.*

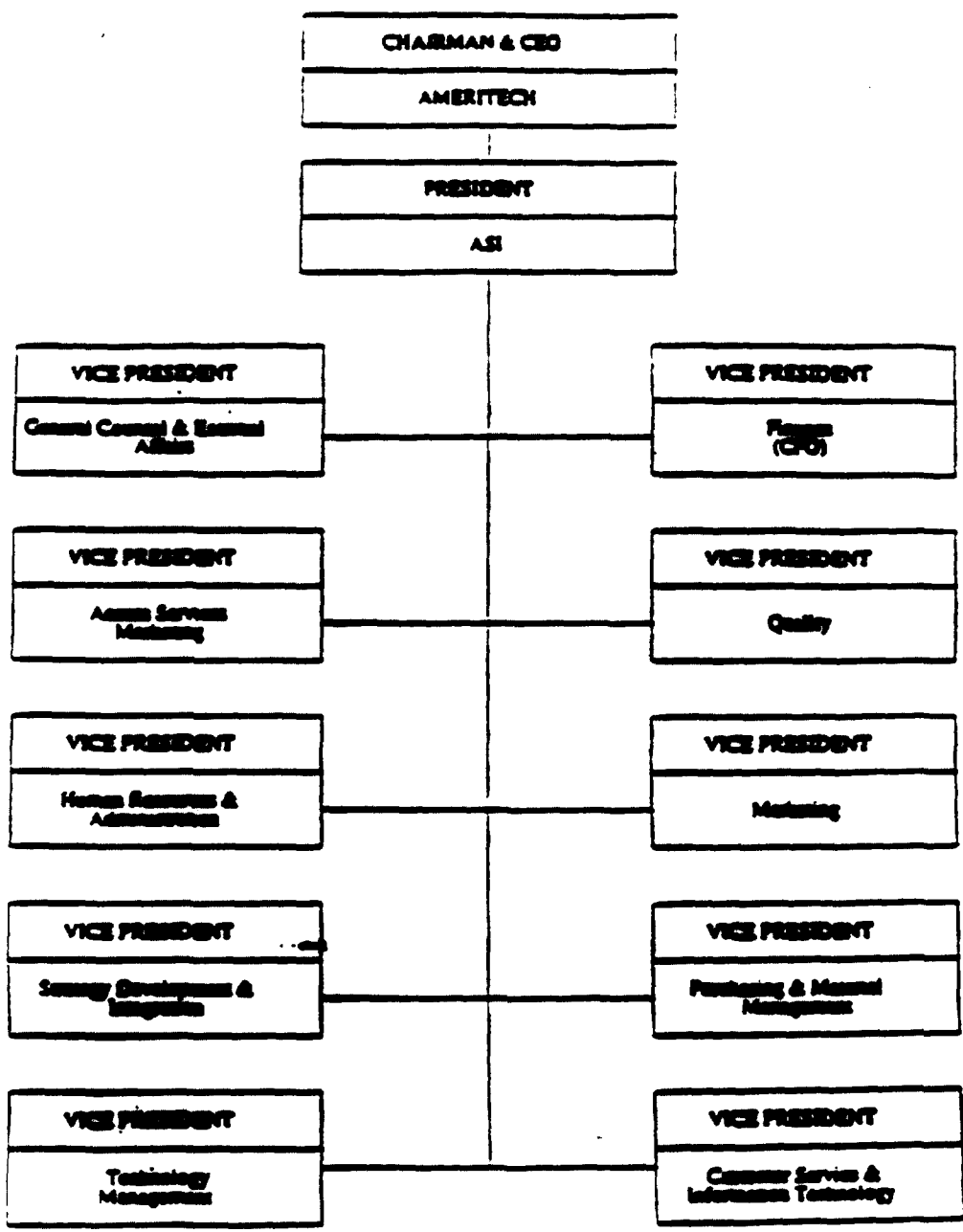
ASI Organization and Associated Services Provided to IBT (and Other Affiliates)

The Ameritech philosophy is that ASI provides services for which the five Ameritech Operating Companies (AOCs) have a common need and which can be more efficiently and effectively provided on a consolidated basis. These services are organized according to broadly focused business processes, such as the establishment of customer service. ASI itself is organized along functional lines, and multiple functional areas may support specific business processes.⁹² The ASI organization structure (consisting of 10 departments) is shown in *Exhibit IV-1*.⁹³

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Exhibit IV-1
ASI Organization
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Exhibit IV-1
ASI Organization
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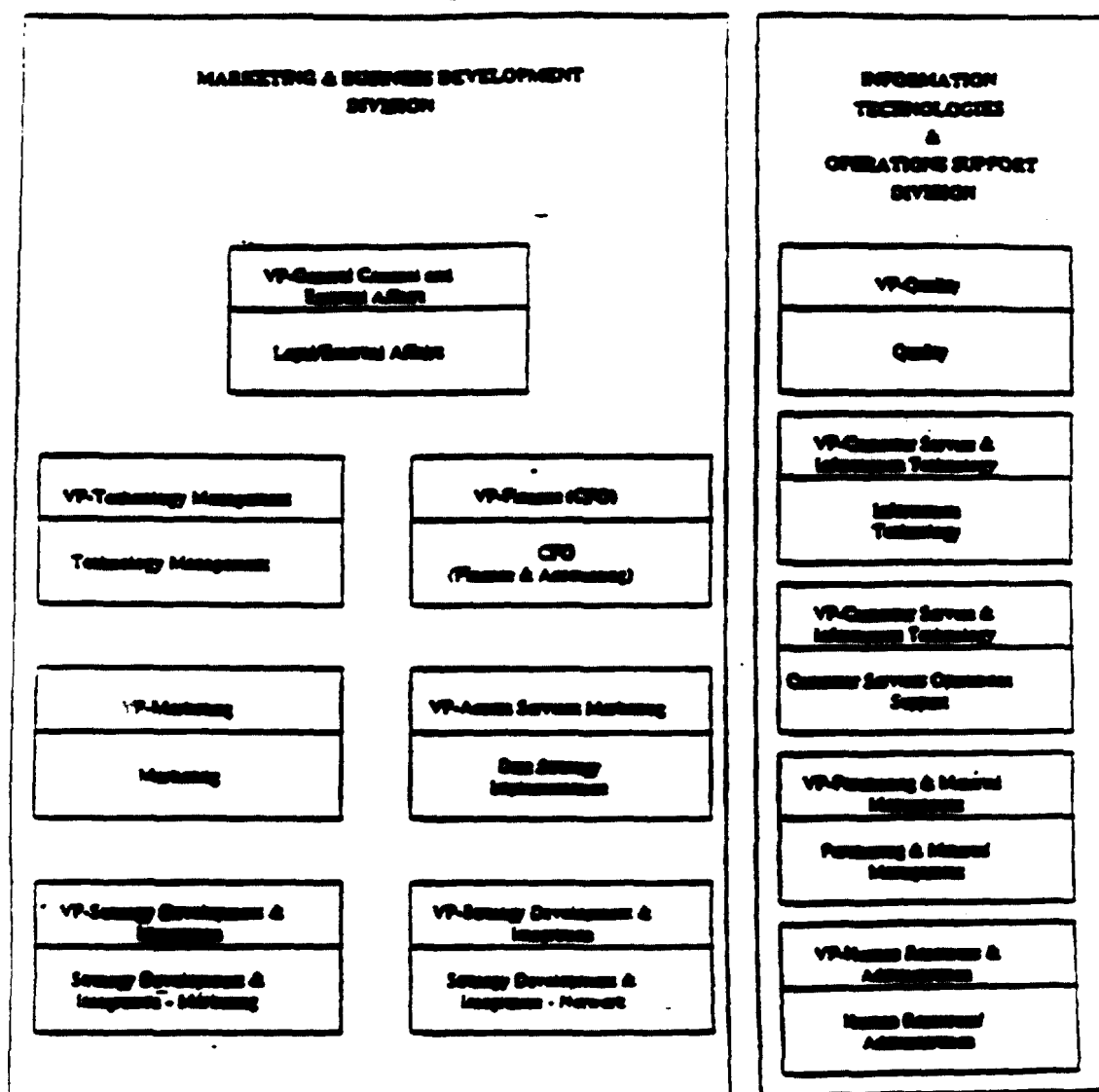
General Counsel and External Affairs	This department prepares and files FCC tariffs, performs capital recovery and separations functions for the region, coordinates state regulatory and legislative policy matters, and serves as the AOCs' lead legal counsel. ¹⁰ The General Counsel (Legal) group is specifically responsible for coordination and direction of all Ameritech Bell Group (ABG) legal organizations. The External Affairs group handles ABG's federal regulatory matters, formulation of ABG regulatory positions for FCC tariffs, FCC dockets, federal agency inquiries, and managing interstate earnings. ¹¹
Access Services Marketing	This department positions Ameritech access products and services in the marketplace by providing the collection, distribution, and fulfillment requirements of interexchange customers. ¹² This department supports the ABG president by evaluating data services opportunities, and also integrates the data strategy with other ABG strategies. ¹³
Human Resources and Administration	This department manages policy development, implementation, and administration of human resource and human resource-related functions. ¹⁴ It provides labor relations policy and support, corporate communications, and consolidated training for Bell Group companies; administers benefit plans and programs; provides health and wellness services; and manages Bell Group benefit plan consolidations. ¹⁵
Strategy Development & Integration	This department performs ABG business planning and development and supports business process management activities. ¹⁶ The Marketing group supports the Ameritech Operating Company (AOC) presidents in developing strategies for (Residential/Small Business, Large/Medium Business, Public, Carrier Services, Information Services) marketplaces serving families. It has responsibility for integrating ABG strategies and development activities, along with marketplace, financial, and human resources into a coherent strategic business unit (SBU) business plan. ¹⁷ The Network group supports the entity presidents in developing strategies for five (Cost Restructuring, Network, Information Technology, Human Resources, Supplier Management) family structures. It has responsibility for integrating non-ABG strategies and development activities. ¹⁸
Technology Management	This department plans the long-term evolution of Ameritech's infrastructure technology, including characteristics of infrastructure elements, supplier products, and standard operating environments. ¹⁹ This group manages ABG's technology base to support current and future marketplaces and internal business needs. ²⁰
Finance	This department is responsible for budget, controller operations, financial management, and accounting standards, and it directs the operations of AOC finance organizations. ²¹ This department establishes and administers budget and accounting policy, develops financial targets, provides accounting methods support, ensures that ABG achieves stated financial objectives, ensures integrity of external financial reports, provides cost of capital expertise, and runs of return support to the AOCs, all on a regional basis. ²²
Quality	This department supports implementation of Ameritech Quality activities and integration with the Breakthrough Leadership program. ²³
Marketing	This department supports the AOCs' sales organizations with centralized (not consolidated) product development, product and market planning, sales channel support, and market communications for the ABG. This department also oversees implementation of Ameritech's data strategy. ²⁴
Purchasing and Material Management	This department performs procurement, warehousing, and distribution functions for ASI and the five AOCs. ²⁵
Customer Service and Information Technology	This department is responsible for strategic direction of establishing, delivering, billing, and maintaining high quality customer service for the ABG's internal and external customers. ²⁶ The Customer Services Operations Support group supports and develops regional support for all front-line employees (including, AOC outside plant, central office, power engineering, and fundamental planning groups), manages ABG billing processes; and supports all major computer systems and many of the "methods and procedures" functions. ²⁷ The Information Technology (IT) group manages the information systems and supporting operational infrastructure for ABG companies. ²⁸

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The services provided by ASI's 10 departments are categorized by ASI into 12 major service categories. Each service is displayed in *Exhibit IV-2*¹¹³, with the respective department that provides the service shown in the top of each box. These 12 services are grouped into two divisions, with seven services comprising the Marketing and Business Development Division, and five services comprising the Information Technologies and Operations Support Division.¹¹⁴

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**Exhibit IV-2
ASI Organization/Service Matrix**



According to Ameritech management, services provided by ASI to the ABG companies (both AOCs and ASI itself) are meant to "support the development and implementation of strategies for stimulating revenue, reducing expenses, and providing high quality telecommunications services."¹¹⁵ The agreement for services provided by ASI to IBT is a two-page document which became effective January 1, 1984. It provides for certain services, including "purchasing.

product selection support, material management, warehousing, computer systems, accounting, auditing, legal recruitment, management, financial, tax, insurance, pension, institutional advertising, research and development, and other services," as well as physical facilities, equipment, and computer systems, to be provided to IBT on an "as-arranged" basis.¹¹⁶ This agreement also provides for ASI to bill IBT on a monthly basis for ASI's cost of any services, facilities, and equipment rendered or made available to IBT during the previous month, and for payment of that bill by IBT within 30 days. This agreement has not been updated or amended since it was issued in 1984. There is a similar agreement between IBT and ASI (also effective January 1, 1984) for services provided by IBT.¹¹⁷

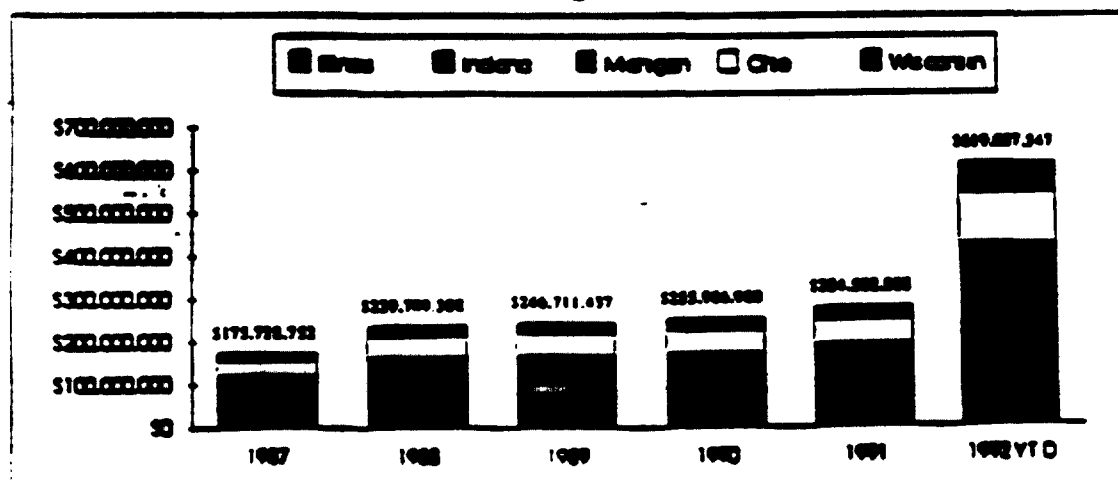
Based upon the consultant's investigations and analysis, as further described in the *Value Testing* section (S-WS-40009) of this chapter, the services provided by ASI to IBT are necessary. Many of the services provided by ASI result from the centralization and/or consolidation of services that were once provided by IBT (and the other AOCs) but which have since been transferred to ASI for the benefit of all AOCs.

IBT Purchases of Services from ASI

*Exhibit IV-3*¹¹⁸ illustrates the dollar level of services provided by ASI to all five AOCs over the last six years (from 1987 to September 1992 year-to-date). The level increased substantially in 1992. A large number of employees were transferred from the AOCs to ASI in 1992; the IBT portion is displayed later in *Exhibit IV-6*. Beginning in 1992, Belcoore charges to the AOCs were included in ASI's books, then passed on directly to the AOCs. IBT's proportion of charges to regulated affiliates has remained close to 30% from 1987 to 1992. The dollar level of services provided by ASI to nonregulated affiliates over this same time frame are not shown in this exhibit, as these amounts are relatively insignificant compared to the charges to regulated affiliates.

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Exhibit IV-3
ASI Services Billed to Regulated Affiliates (AOCs)



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Exhibit IV-1¹¹⁹ further delineates ASI's services billed (shown in Exhibit IV-3), and other UT expenses, by ASI department.

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Exhibit IV-4
Breakdown of Expense Charges from ASI to IBT
(\$ in Thousands)

	1989	1990	1991	1992
Legal/External Affairs	8,713	11,050	13,454	16,077
Business Development			1,713	1,309
Marketing	27,478	30,322	41,221	51,427
Technology Management	22,421	16,333	18,962	21,213
Strategy Development & Integration			2,666	4,559
Access			7,350	33,812
Quality		120	2,258	861
Information Technology	253,800	284,676	347,313	390,224
Customer Services	23,434	27,984	33,318	68,488
Purchasing/Materials Management	87,411	89,802	80,130	76,409
CFO/HR	30,911			
CFO		14,743	17,122	22,003
HR		43,292	85,191	128,605
Corporate Expense & Other	12,232	15,082	1,558	11,112
TOTAL	486,400	533,210	652,256	826,098

Asset Transfers

The practices used for asset transfers between ASI and the AOCs include having a letter agreement and invoice for supporting documentation. Asset transfers from ASI to regulated AOC affiliates are recorded at the lower of market or cost. Asset transfers from regulated AOC affiliates to ASI are recorded at the higher of market or cost.¹²⁰

For 1987 forward, assets that have been transferred to ASI from IBT have consisted primarily of equipment, valued at \$674,149 (book value) during 1990 and 1991 as shown in Exhibit IV-5.¹²¹ This equipment comprised machinery and warehouse equipment (\$259,452), office equipment (\$4,019), computer equipment (\$211,609), and technical equipment (\$199,069). During this same time frame, asset transfers from ASI to affiliated companies were infrequent; no assets were transferred to IBT.¹²²

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Exhibit IV-5
Asset Transfers Between ASI and IBT

Year	From	Value	Description	Basis
1990	Illinois Bell	144,049	Computer Equipment	Book
1991	Illinois Bell	530,100	Equipment	Book

These figures are for calendar years; therefore, a direct tie-in with Chapter VIII Exhibit VIII-2 figures (on a half-year basis) is not included

Employee Transfers

Exhibit IV-6 illustrates the number of employee transfers between ASI and IBT for 1989 through 1992.

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Exhibit IV-6
Employee Transfers Between ASI and IBT

	1989	1990	1991	1992
Employees Transferred from ASI to IBT	21	19	40	58
Employees Transferred from IBT to ASI	61	48	213	889

Employee transfers between the two companies generally increased each year; only 1990 reflected a decline in transfers between ASI and IBT. Less than 100 employees have transferred to IBT from ASI each year since 1989. Transfers to ASI from IBT, however, have jumped substantially during both 1991 (when 213 employees transferred) and 1992 (when 889 employees transferred to ASI).

Costs Traditionally Excluded from Illinois Revenue Requirements

In the past, the Illinois Commerce Commission has not specifically disallowed any of ASI's charges to IBT; however, some cost categories are traditionally excluded from Illinois revenue requirements, including corporate-image advertising and lobbying.¹²³ Typically, there are relatively few ASI charges to IBT for corporate-image advertising or lobbying, according to IBT and ASI management; these services are primarily provided by Ameritech Corporate.¹²⁴

EVALUATION OF SELECTED MANAGEMENT PROCESSES

S-WS-40002 *Determine if decision processes and underlying analyses employed in determining the selection and use of external vendors (including non-affiliates and affiliates) for the development and delivery of services to regulated operations is appropriate.*

This section addresses IBT's initiation process for purchases from all affiliates and non-affiliates. IBT does not have any formal procedures for determining whether an affiliate or non-affiliate, or both, should be considered when contemplating the purchase of goods and/or services. Once IBT determines that an affiliate, or a non-affiliate, is to provide the goods and/or services, IBT follows different procedures, depending on whether the vendor is an affiliate or non-affiliate.

Provision of Goods and/or Services from Non-affiliates

IBT has procedures in place that cover all areas of purchasing from non-affiliates, including bid, evaluation, and selection.¹²⁵ ASI also has similar procedures in place that define its purchasing process.¹²⁶

Provision of Goods and/or Services from Affiliates

Various functions have been consolidated/centralized at specific IBT affiliates, including ASI; however, IBT does not have formal procedures for the selection of an affiliate as a provider of goods/services. Initially, information technology (I/T)¹²⁷ was consolidated, then marketing,¹²⁸ followed by human resources, public relations, advertising, legal, costing, capital recovery, separations, security, financial services, accounting, engineering, and administrative services.¹²⁹ IBT relies partly upon centralization studies to assess the competitiveness/effectiveness of affiliates providing goods/services. These centralization studies often do not include a cost comparison to an external provider, if a strategic decision has been made to centralize a function. For example, when IBT accepted Ameritech's decision (with AOC involvement) to centralize purchasing at ASI, IBT acknowledged that the price of specific goods may be above or below market prices; however, based upon management's conviction that centralization generally benefits ratepayers, the company believed that overall centralization of the purchasing function yielded savings. Similarly, when information systems and marketing activities transferred to ASI, outsourcing was not considered as part of the centralization studies.¹³⁰ Ameritech's stated goals of centralization have been to:¹³¹

- Shift resources to revenue growth initiatives
- Standardize products, services, and systems
- Eliminate duplication
- Shift to a business process orientation
- Increase operating efficiencies
- Improve speed of decision making

While, philosophically, centralization/consolidation is often considered advantageous (for example, when resulting in increased economies from performing an activity one particular way rather than five different ways, or from the intention to select the "best of breed" in operating systems), it is important for a company to verify that the original goals and objectives of centralization/consolidation are actually attained. While functions have been centralized/consolidated out of IBT, IBT has not verified on a formal, systematic basis that savings were actually achieved. It is unknown whether the anticipated level of savings actually resulted, as this information and data is not available.¹³² For example, in 1987, an information systems centralization study was conducted, during which both expense and headcount projections through 1992 were identified. However, until a response to a data request in the course of the IBT reconnaissance audit (performed by the Illinois Commerce Commission) had to be developed, IBT had attempted neither to track projections to actual nor to document results.¹³³

S-WS-40003 *Determine if the management processes employed by IBT to govern its various affiliates are appropriate in that they provide the input and control necessary for effective management.*

IBT believes that it exercises control over ASI's work in two major ways:¹³⁴

- Through actions of the ASI Managing Board, which approves ASI's total budget and the particular services ASI provides
- Through IBT's affiliate management process (AMP), which provides for ongoing interaction (input, evaluation, approval, and performance management of deliverables) between the ASI managers providing services and the IBT managers who are beneficiaries of such work

Furthermore, each AOC president brings the concerns of his operating company to the monthly meetings of the Office of the Bell Group Presidents (OBGP) where strategic decisions, strategies, initiatives, and directions are determined. The OBGP consists of the presidents of the five AOCs, ASI, AIS, and the ABG. The OBGP charts the direction of the operating companies, partially through strategic families and strategies. In particular, it sets forth the tasks to be pursued and completed by ASI specifically and ABG generally. There were 11 strategic families (strategies) during 1992; each family is under a OBGP president and is supported by a committee, including members from each OBGP organization and additional support staff from ASI.

ASI Managing Board

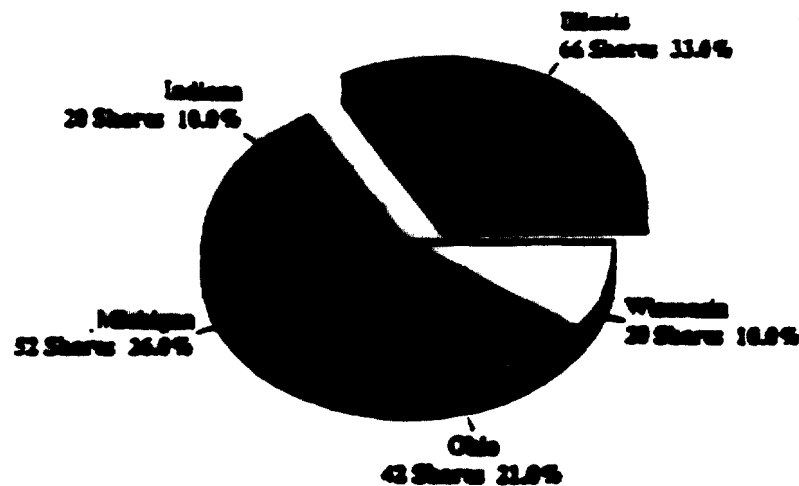
The ASI managing board is responsible for providing direction to ASI on behalf of the stockholder; electing officers to one-year terms; approving budgets, work programs, cost of capital, and allocation factors; and declaring dividends and shareholder distributions. Its members include each of the five AOC presidents, the ASI President, and a secretary (ASI Vice President - Finance). On policy and administrative matters, each board member (except the secretary who is a non-voting member) has one vote. On matters pertaining to expenditure of

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funds or capital contributions, each AOC board member is entitled to vote the shares of voting stock owned by his or her respective AOC, such actions must be approved by at least 60% of the outstanding shares of stock.¹³⁵ The five AOCs' ownership of ASI is detailed in *Exhibit IV-7*.¹³⁶

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Exhibit IV-7
Relative Ownership of ASI by the Five AOCs



Presently, there are 200 shares of ASI stock; 100 was divided among the AOCs when ASI was created, and an additional 100 shares resulted from the merger of Ameritech Applied Technologies, Inc. and Ameritech Services, Inc. in 1991. IBT's relative ownership today is the same as it was prior to the ASI/AAT merger.¹³⁷

Affiliate Management Process

No one organization within IBT receives, reviews, processes, administers, and monitors all affiliated transactions. These responsibilities reside throughout the IBT organization. In the past, the organizations receiving the services/goods received the monthly bills and were responsible for reviewing, monitoring, and paying the charges. Effective January 1, 1992, IBT's Assistant Vice President (AVP)/Comptroller was given corporate responsibility for budgeting, receiving (including bill receipt, verification, and payment functions), and assessing affiliated costs. This represented a major policy change from previous years in that AST's costs were no longer budgeted within IBT at the department level but at the IBT corporate level.¹³⁸

The primary process used by IBT for managing ASI work is AMP, which was previously implemented on January 1, 1991, as a result of an ABG task force.¹³⁹ The Director of Financial Forecasts is IBT's AMP coordinator and IBT's representative on the ABG Task Force on Affiliated Interest.¹⁴⁰ AMP requires that AST's work efforts and budget be categorized as either business management work activity or project management work activity.¹⁴¹ All of AST's work efforts for supporting the five AOCs are documented in work profiles, which are used for grouping resources based upon integrated objectives and funding levels and for apportioning ASI resources among work efforts. For 1992, approximately 220 ASI work profiles were

budgeted into 16 business processes.¹⁴² Of the 1992 budgeted dollars, over 90% of ASI's budget represented work that was a continuation of efforts from 1991.¹⁴³ Business management work activities comprise approximately 80%¹⁴⁴ of ASI's work efforts, while project management work activities comprise approximately 20%.¹⁴⁵ Of these two types:

- Business management work activities reflect infrastructure work, such as efforts required to operate the current business, and include items such as product/market/channel management, technical support to front-line operations, personnel staffing, accounting operations, and legal.¹⁴⁶ Various business management work activities support each business process.¹⁴⁷
- Project management work activities cover work efforts of a discrete nature and shorter duration, with identifiable start and stop dates, and focus on changing the business.¹⁴⁸ They include new product introductions, mechanization of existing processes, and design of new processes, technologies, etc. For resource allocation decisions, project management work activities are grouped into three categories — strategic projects, non-strategic continuing projects, and non-strategic (new) projects¹⁴⁹ — which comprised approximately 11 strategic and 192 non-strategic efforts in 1992.¹⁵⁰ Strategic projects (also known as strategic initiatives or strategies), or 65% of the project management work activity,¹⁵¹ represented work approved by the OBG¹⁵² through a four-stage approval process (opportunity analysis; business case analysis; implementation/transition plan; and performance objectives and monitoring).¹⁵³ Transitioning the 11 strategies is the responsibility of ASI's Vice President/Chief Financial Officer.¹⁵⁴ In addition, a Shareholder Agreement and the by-laws of ASI set forth that if holders of 60% of ASI's shares vote to initiate a project, then all AOCs must participate. If work does not receive the 60% vote requirement, the AOCs can refuse the work effort.¹⁵⁵ Of the two remaining categories of project management work activity, non-strategic continuing projects represent those previously approved and funded projects on which work is progressing into subsequent years according to its approved plan.¹⁵⁶ Non-strategic (new) projects represent new work proposals that do not specifically require OBG review and approval.¹⁵⁷

Work Profiles

ASI's costs are accumulated into work profiles (and bill lines) for billing the AOCs. These are based primarily upon direct assignment and the use of a regional allocator formula.¹⁵⁸ IBT's allocation using this formula, which is adjusted to reflect the number of AOCs participating in and benefiting from the work activity, approximates 30 percent.¹⁵⁹ Further elaboration of cost assignment/allocation methodologies is provided in a later section of this chapter.

From 1992 forward, the Resource Allocation Process (RAP) created work profile documents to replace ASI's work packages (which described professional services provided by ASI) and product service orders (PSOs) (which described information technology work efforts provided by AAT, and subsequently ASI).¹⁶⁰ In 1991, there were approximately 700 PSOs and 175 ASI work packages.¹⁶¹ In 1992, there were approximately 300 ASI work profiles, which integrated professional services and information technology.¹⁶²

Work profiles are used for allocating resources while integrating objectives and funding levels. A work profiles form is used to document resource allocation decisions, affiliate interest requirements, and objective setting; it also provides the means for tracking. Work profiles are organized into business processes and reflect the resources of various ASI organizations. Included in a work profile document are customer identification, key assumptions, benefits, resource requirements, description of work, dependencies and prerequisites, and deliverables/objectives.¹⁶³ Both expense and capital dollars are also included. Upon initiation of a work profile, ASI completes a work profiles document and distributes it to the AOCs for approval.¹⁶⁴ Specific work efforts within a work profile are broken down into bill lines (for accumulation of charges) and projects. ASI's profile and project owners have overall responsibility to manage ASI's work efforts and deliver the benefits on time and within budget to recipients at IBT (IBT's profile and project managers).¹⁶⁵

An addendum to a work profile is the one-page benefit verification form, which is used to document the used and useful nature of the ASI services being provided to the AOCs. The AOCs complete these forms, attesting to the benefit/necessity of the work activity described, and send copies to ASI. When ASI is the recipient of a work activity described by a work profile, an ASI manager completes the associated benefit verification form.¹⁶⁶

Business Processes

A business process is a series of linked work activities that produce a result that may be an internal product, a service, or a deliverable that supports the AOCs' business. Business processes are directed by process owners, who are ASI senior managers, vice presidents or assistant vice presidents.¹⁶⁷ The ASI process owners set priorities, approve deliverables, and approve funding for the efforts included in their respective business processes.¹⁶⁸ At IBT, senior executives constitute the process managers, who function as IBT's counterparts to ASI's process owners. The IBT process managers are responsible for monitoring and assessing the work efforts performed by ASI for IBT.¹⁶⁹

Other Management Processes

Work Profile/Part 64 Documentation

Each year a formal work profile document is developed by ASI and approved by IBT, in which the activities to be performed and the deliverables to be provided (by work profile) during the upcoming year are established.¹⁷⁰ Furthermore, to ensure compliance with Part 64, IBT completes a quarterly affiliate transaction checklist, in which services actually provided by ASI and asset transfers completed during the specific quarter are listed. This checklist — prepared by the IBT contract administrator, reviewed by the Part 64 AOCs Cost Allocation Manual (ACAM) coordinator, and approved by the Part 64 compliance director — is designed to enable IBT and ASI management to verify that transactions occurred as anticipated.¹⁷¹

Planning and Budgeting

ASI's Vice President/Chief Financial Officer has responsibility to establish the overall schedule collect work profiles, maintain any databases, issue reports, and perform other such duties to

facilitate ASI's Resource Allocation Process.¹⁷² The RAP was originally established in 1991 and its goal is to identify, prioritize, and allocate ASI resources.¹⁷³ It consists of four phases: identification of ABG desired work efforts; prioritization of work proposals; allocation of work and funding levels; and approval of work programs and funding levels.¹⁷⁴

Through strategic planning, the OBG identifies business processes, strategies, and legal mandates which are funded first during the budget process. A graphical illustration of the budgeting process is provided in *Exhibit IV-8*.¹⁷⁵ Once strategic activities are funded, the remaining budget (approximately 7%) is available for non-strategic continuing projects and non-strategic new projects. Prioritization of the underlying work profiles of non-strategic continuing projects and non-strategic new projects is performed by the Resource Allocation Committee (RAC) during the RAP.¹⁷⁶ The RAC members consist of ASI employees who have knowledge of the needs of IBT's process managers. The RAC considers all requests and evaluates them against available funds to develop proposed work profiles and prioritize those work profiles. The proposals are submitted to ASI's process owners, who make the decisions determining which work profiles to fund and have ultimate responsibility to equate available funds with work profile costs and the needs of the AOCs.¹⁷⁷ ASI prepares and approves the work profiles, and then submits them to the AOCs for approval.¹⁷⁸ From the work profile information, ASI prepares its final budget by work effort and organization. IBT personnel compile work profiles, associated cost estimates, and benefit statements, then provide them to the respective AOC process managers. The latter review the information and make recommendations to their respective presidents regarding acceptance of an ASI work profile.¹⁷⁹ The IBT President provides written consent and acknowledgment regarding the services provided by ASI to IBT.¹⁸⁰

In the early part of the year, around March, IBT receives its portion of ASI's preliminary budgeted costs as two numbers: ASI's costs and Belloc's costs. IBT goes through a prioritization process similar to ASI's RAP and gives its preliminary budget data to ASI around May.¹⁸¹ Upon receiving updated ASI work profile budget data, IBT incorporates this data and updates its proposed budget, which is submitted to the ABG and Ameritech for final approval.¹⁸²

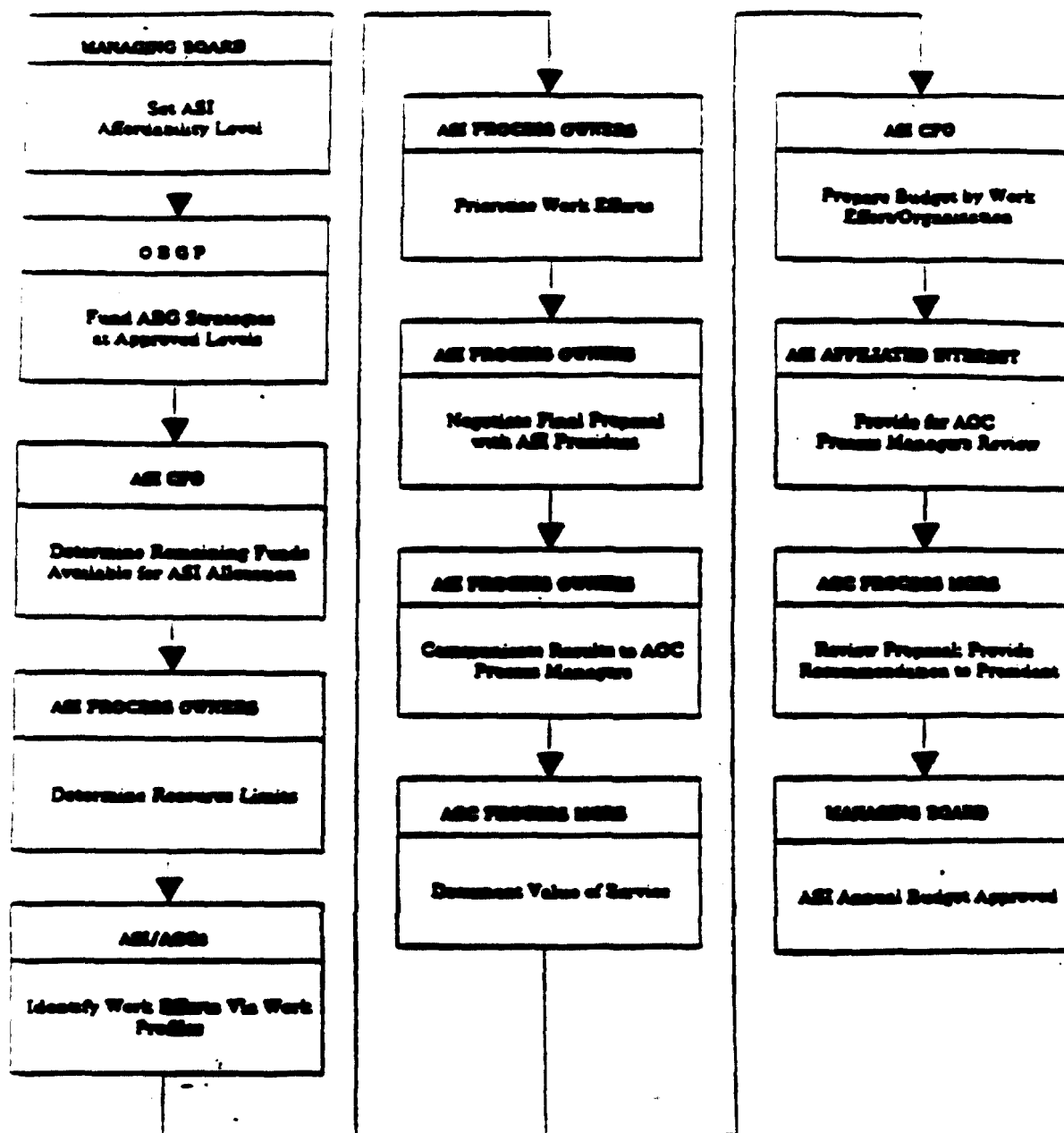
Delivery Tracking

Previously, neither ASI nor IBT had a system to track ASI deliverables for each work profile.¹⁸³ Only budget to actual results for product service orders were monitored; not deliverables.¹⁸⁴ In 1992, however, the use of a delivery tracking report was established and provided to IBT's profile managers.¹⁸⁵

Quality Assessments

IBT does not formally and routinely review and assess the quality (or costs and benefits) of professional services provided by ASI to IBT.¹⁸⁶ A recent example of an IBT-initiated cost comparison study performed by an external consulting firm contained the following four components: survey of corporate services; telecommunications industry survey; survey of marketing; and information technology survey.¹⁸⁷

Exhibit IV-8 Budgeting Process



The following text identifies any findings and conclusions associated with work steps S-WS-40001, S-WS-40002, or S-WS-40003 included in the *Relationship Assessment, Background, and Perspective* section (Section A) of this chapter.

IV-F11 The decision processes and underlying analyses employed in determining the selection and use of external vendors (including affiliates) for the development and delivery of services to regulated operations is not appropriate and frequently not properly documented when formal processes are performed.

The activities performed by IBT management in determining whether to use an external vendor (including affiliates, particularly ASI) versus IBT in performing work are often informal. Based upon the auditor's investigations and analyses, as further described in this section and summarized in the *Value Testing* section (S-WS-40009) of this chapter, some functional areas within ASI formally evaluate alternative sources for provision of services; some do not. Furthermore, IBT has not verified on a formal, systematic basis that savings have actually been achieved by provision of service by affiliates. This informality and subsequent lack of supporting documentation is unacceptable for an organization that primarily serves Ameritech's regulated operations.

IV-F22 The recording of ASI charges at the IBT corporate level results in lowered accountability by IBT users.

Since January, 1992, those charges from ASI to IBT have been recorded on IBT's books at its corporate level; previously those charges were recorded individually at the departmental level. In the past, the AVP/Comptroller generated reports regarding affiliate charges that were distributed throughout IBT. The IBT department heads received monthly gross budget-to-actual amounts which they used to track affiliate costs billed to their departments. The responsibility for monitoring specific affiliate costs was pushed down into the organization so that those who worked directly with the affiliate monitored the costs. The responsibility for the resolution of budgeting and billing disputes started at the level directly receiving the service, then escalated to the division heads, department heads, and eventually IBT's President. The AVP/Comptroller is now responsible for monitoring and tracking affiliated costs.¹⁸ The use of AMP alone — when tracking of affiliate costs at the departmental level is not used by users — is not sufficient for holding users accountable for managing ASI's work. The inclusion of ASI charges in departmental budgets increases awareness of affiliate charges by IBT managers. In the long term, the recording of affiliate charges at a lower level within IBT may reduce the overall allocations to IBT as IBT managers seek ways to control growth in these costs — especially if their compensation is affected by budget overruns. The Ameritech organization states that, often, those individuals most knowledgeable of the need of IBT users are no longer within the IBT organization. This may be true; however, for IBT users to have appropriate checks and controls over ASI work (as process, profile, or project managers), then they should also be held financially responsible for what work is performed on their behalf. As long as the owner (ASI)/manager (IBT) relationship is maintained between ASI and IBT management, budgeting affiliated costs at a corporate level hampers monitoring and control.

IV-F33 The market value of asset transfers is not properly documented.

Although no assets were transferred from ASI to IBT during the audit test year, some were transferred in the opposite direction from IBT to ASI. The market value of asset transfers between ASI and IBT, however, is not properly documented, regardless of the direction. The \$674,149 transferred from IBT to ASI in 1990 and 1991 was equipment recorded at book value

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Ameritech's procedures in this case are to transfer at the higher of market or cost (book value). While book value may likely be the higher of market or cost, little documentation exists. For example, 31.4% (\$211,609) of the \$674,149 transferred was computer-related. Refer to *Chapter VIII* for further elaboration of asset transfers from IBT to ASI for the audit test year (September 1, 1991 and August 31, 1992). The consultant met with the ASI employee who is responsible for establishing market value of all computer equipment transferred between ASI and IBT, regardless of direction. Although outside sources are used to determine market value, supporting documentation is not kept by this employee regarding specific transactions. Instead, the market value is provided verbally to IBT for determination of the greater (or lower) of market or cost, whichever is applicable.¹⁸⁹ This lack of supporting documentation is imprudent on the part of IBT.

Recommendations

The following identifies any recommendations associated with work steps S-WS-40001, S-WS-40002, or S-WS-40003 included in the *Relationship Assessment, Background, and Perspective* section of this chapter.

IV-R14 Develop specific policies and procedures in which ASI and IBT management is required to properly document the selection and use of external vendors (including affiliates) for the development and delivery of services to regulated operations and the subsequent monitoring and tracking of results achieved. (Refer to Finding IV-F1)

Through the AMP and RAP processes, each of ASI's functional areas should be required to justify why the ASI organization has been selected to provide specific services to Ameritech's regulated operations — versus IBT or external vendors. When the AOCs are considering transferring services to ASI, a formal cost/benefit analysis should be performed and retained in a centralized location for easy access by regulators. For services which have traditionally been provided by ASI, ASI management should be required to regularly and routinely reexamine whether ASI is still the optimal way to provide services to the AOCs. In this situation, a formal cost/benefit analysis also should be developed and retained.

After decisions have been made to consolidate/centralize services at ASI, and implementation has occurred, monitoring and tracking of actual results achieved must be performed.

IV-R25 . Improve accountability of ASI charges to IBT by having affiliate costs reported in departmental budgets. (Refer to Finding IV-F2)

The practice used before 1992 of having ASI affiliate costs reported in IBT departmental budgets should be reinstated, as long as business processes, work profiles, and projects are managed by IBT and owned by ASI.

IV-R36 Maintain supporting documentation regarding determination of market value of transfers. (Refer to Finding IV-F3)

Supporting documentation, including copies of outside source publications, as to how market value is determined for specific transactions should be kept by IBT (and/or ASI) personnel.

Because IBT is a regulated entity, it must operate in such a manner that raises few questions from regulators regarding the appropriateness of asset transfers.

B. VALUE AND COST ASSESSMENT

This section summarizes the consultant's assessment regarding both value and cost for affiliate transactions from ASI to IBT. The following three major phases were required in performing the activities and work steps involved:

- Regulatory Impact Model (RIM) Development
- Sample Identification
- Transaction Testing

The scope and objectives of the RIM Development phase were threefold. Initially, through review of cost accumulation/assignment and allocation methodologies, a familiarity of the processes involved was gained. The underlying bases and factors employed by ASI and IBT were then used in loading RIM. Through loading and analyzing RIM source data, as well as other techniques (described later in the *Sample Identification* section of this chapter), the consultant identified those ASI work efforts where further investigation and analysis were required. The specific investigation and analysis activities are described in the *Transaction Testing* section of this chapter; essentially, sampling of transactions was performed to ensure the accuracy of IBT's internal control procedures and to identify any disallowable costs. Finally, sensitivity analyses were performed using RIM; these included alternative cost allocation bases and factors identified during transaction testing.

COST APPORTIONMENT PRINCIPLES, POLICIES, AND PROCEDURES

Cost apportionment policies and procedures developed by ASI are set forth in the "Ameritech Services Cost Allocation Manual" (CAM). The manual describes the methods and procedures that ASI uses to allocate total company costs for transactions with its affiliates and non-affiliates, including the billing of such costs and related methods and procedures.¹⁰⁰ The purpose of the manual is to provide an understanding of the various methodologies pursuant to regulatory requirements prescribed by the FCC for the prevention of cross-subsidization of costs for transactions between regulated and nonregulated affiliates.¹⁰¹ In Docket 86-111, the FCC established two separate but complementary sets of rules. One set defines a cost allocation process to separate the costs and account for regulated and nonregulated activities offered by a carrier. The other set governs the regulated accounting treatment for transactions for goods and services between a carrier and its nonregulated affiliates. The FCC implements and enforces these rules by requiring carriers to file and maintain current cost allocation manuals demonstrating in detail the application of these rules to their particular operations. The cost allocation procedures described in ASI's CAM are designed by company management to portion costs in a cost causative manner uniform with FCC Regulations and similar requirements adopted by the Illinois, Indiana, Michigan, Ohio, and Wisconsin public utility commissions.

In accordance with generally accepted accounting principles, ASI's total costs are divided into accounts; these accounts correspond to activities. The reason for apportioning ASI's total costs among all of its activities is to enable ASI to provide information comparable to the information required under Part 64 and similar requirements of the five states' public utility commissions.

¹⁹³ The principles and procedures contained in the ASI CAM are supposed to guard against subsidy of nonregulated activities and to describe transactions between regulated and nonregulated affiliates. Transactions with regulated affiliates include services provided to the five AOCs and common services provided to the AOCs through Bellecore; other transactions are primarily with nonregulated affiliates.¹⁹⁴ For separating costs between regulated and nonregulated activities, ASI uses cost apportionment and accounting principles which group costs into four apportionment categories. The four cost categories and the principles used to make the groupings are defined in the AOCs Part 64 Cost Allocation Manual, as follow:

- **Directly Assignable Costs** — Investments or expenses incurred exclusively for either regulated services or nonregulated activities. The source for these costs is usually time reporting and expense vouchers.¹⁹⁵
- **Directly Attributable Costs** — Investments or expenses incurred for both regulated services and nonregulated activities that can be apportioned using direct measures of cost causation, such as usage.¹⁹⁶
- **Indirectly Attributable Costs** — Investments or expenses incurred for both regulated services and nonregulated activities for which there is an indirect measure of cost causation that will relate the costs to the final regulated or nonregulated cost category.¹⁹⁷
- **Unattributable Costs** — Investments or expenses that are shared between regulated services and nonregulated activities, and for which no direct or indirect causal relationship exists.¹⁹⁸ The use of a general allocator for time reporting and expense vouchers is an example.¹⁹⁹

Transactions between regulated and nonregulated affiliates are governed by contracts or service agreements documenting the nature and terms of the intended transactions. The State of Illinois has an affiliated interest statute that requires IBT to file contracts and services agreements with the ICC.²⁰⁰ These transactions are recorded by IBT in its regulated books based upon the rules in Section 32.27 of the FCC's Uniform System of Accounts for Telecommunications companies. Affiliate transaction rules also apply to transactions between nonregulated affiliates to the extent that the costs associated with these transactions are subsequently transferred to regulated carriers through secondary transactions.

The pricing of individual affiliate transactions depends upon the specifics of each transaction, as follows:

- **Tariff Rate** — This is the price charged to customers under applicable tariffs on file with federal or state regulatory commissions. Tariff rates are used for pricing transactions with affiliates involving the provision of tariffed services.²⁰¹

- **Prevailing Price (Market Rate)** — This is the price held out by the providing entity to the general public in the normal course of business. Prevailing prices are used for transactions with affiliates if like transactions provided to nonaffiliates constitute a substantial portion of the providing entity's total revenues from such transactions.²⁰¹ Except for possibly pricing asset transfers, the market prices are generally not used.
- **Cost (Fully Distributed Costs)** — This is the amount recorded for transactions with affiliates for which no tariff rate or prevailing price is applicable. The cost of services is determined by applying a fully distributed costing model which, according to ASI and IBT management, emphasizes the assignment of costs based on causation and would include all costs reasonably allocable. It is determined by applying cost allocation standards of Section 64.901 of the FCC's Rules. The cost of assets transferred is determined pursuant to the requirements set forth in Section 32.27, commonly known as the FCC's Affiliate Transaction Rules.²⁰²

RIM DEVELOPMENT

Review Cost Accumulation and Assignment Methodologies

S-WS-40004 *Determine whether ASI has appropriate and fully supported procedures in place for accumulating and assigning costs, and whether these procedures are well-defined and consistently applied.*

Using Ameritech's terminology, the assignment and accumulation of ASI costs are generally categorized as being either directly assigned or indirectly attributable to work profiles/bill lines. Those costs typically designated as directly assigned include wages, benefits, employee-incurred expenses, and outside vendor expenses. Those costs typically classified as indirectly attributable include occupancy, direct administration, and overhead (corporate services, accounting operations, and administrative services).²⁰³ The use of the terminology "directly assigned" is somewhat misleading. It includes not only those costs directly charged to IBT-specific work profiles/bill lines/projects through employee time/expense reporting or through the accounts payable process, but it also includes those costs that initially are directly charged to work profiles/bill lines/projects benefiting multiple AOCs and subsequently are allocated to IBT (or the other AOCs). In this situation, the costs "directly assigned" may include costs allocated via a general allocator based upon Total Operating Expenses (TOE) and Total Plant In Service (TPIS). This TOE/TPIS allocator is discussed in detail later in this chapter.²⁰⁵

Indirectly attributed costs are assigned to work profiles/bill lines using various methodologies, including:²⁰⁶

- Occupancy expenses are accumulated by location to responsibility centers based upon square footage; a square footage table is then used to exclude selected areas, such as data processing, transportation shipment points ("trans ship" locations), Ameritech Mobile Communications (AMCI), etc. that are directly assigned by ASI to specific affiliates; then the remaining occupancy charges are allocated to projects based upon "directly assigned" hours.

- Direct administration expenses are accumulated by responsibility center and allocated to projects based upon "directly assigned" hours.
- Overhead charges are allocated as follows:
 - Corporate services (executive, finance, auditing, labor relations, legal, etc.) are allocated to work profiles/bill lines based upon "directly assigned" hours.
 - Accounting operations are allocated to work profiles/bill lines based upon "directly assigned" dollars.
 - Administrative services (human resources, etc.) are allocated to work profiles/bill lines based upon "directly assigned" hours.
- Data processing center (personnel, hardware, software, and occupancy)²⁰⁷ expenses are categorized to cost pools by project, then allocated based upon the following Multiple Virtual Storage (MVS), Integrated Controls System (MICS) usage statistics:
 - CPU (Central Processing Unit) - seconds
 - DASD (Direct Access Storage Device) - connect time
 - PRINT - print feet
 - TAPE - count of tape mounts
- Other adjustments are recorded as necessary.

Furthermore, a cost of capital is also included in ASI's costs, as designated in the ASI stockholders' agreement; this rate is based upon a weighted average of the AOCs' interstate and intrastate rate of return.²⁰⁸ During the audit test year, for example, approximately 2.6% of ASI's total services billings were based on cost of capital calculations.²⁰⁹

Findings IV-4, IV-5, and IV-6 address ASI's policies and procedures in place for accumulating and assigning costs, as well as its allocation methodologies.

Review Allocation Methodologies

S-WS-40005 *Determine whether the direct billing and allocation methodologies used by IBT and its affiliates, specifically ASI, are founded upon reasonable and fair factors and bases.*

While the majority of dollars charged by ASI to IBT are based upon services billing, other types of ASI affiliated transactions billing occur. The major categories of ASI affiliated transactions billing are:²¹⁰

- Services billing
 - Professional services (ongoing services and special projects) and associated expenses
 - Procurement services and associated expenses
- Conduit billing (non-ASI expenses billed to the AOCs by ASI acting as the AOCs' agent)
- Procurement (warehouse) billing for stock items (shipments, returns, and miscellaneous credit detail)

- Procurement (warehouse) billing for non-stock items (direct or flow-through billing)
- Beltcore flow-through billing

Over 99% of ASI's work is performed for its stockholders — the five AOCs. Supplementing the ASI/TBT services agreement is the stockholders' (or owners') agreement, which specifies management processes, charging mechanisms, etc., between the five AOCs and ASI. For example, if work is performed for only one AOC, the AOC is expected to pay for all of that work. If work that is approved by the ASI Managing Board will be performed for more than one stockholder, the stockholders' agreement specifies that the stockholders for whom the work is being performed shall pay all of the costs of such work.²¹¹

If particular work is performed for non-stockholders as well as multiple stockholders, stockholder recipients are expected to pay their share of costs, after deducting any payments from non-stockholders. The charges billed to non-stockholders are determined at the time work is approved, and the stockholders' agreement provides "that in no event shall any non-stockholder pay less than its share of the Corporation's fully allocated cost of performing such work were it a stockholder."²¹²

Services billing occurs monthly from Ameritech Cost Accounting System (ACAS) for non-procurement items and from ACAS via a Cost Management Analysis Report (CMAR) module for procurement items. Professional services billing is primarily based upon personnel expenses (wages, benefits, and employee-incurred expenses) and outside vendor expenses. The hierarchy used by ASI is generally direct billing, followed by allocation. In direct billing, time and/or expenses are specifically designated to projects. Some projects are AOC-specific; others are regionally based in nature. For these latter type of projects, the TOB/TPIS allocator is used to allocate expenses. For indirectly attributable expenses, allocation (as previously described) is used. Procurement services billing recovers time and expenses related to regional purchasing and materials management activities, including:²¹³

- Direct expenses (primarily wages and benefits, depreciation, occupancy, transportation) relate specifically to a particular AOC and include local warehouse operations and associated buyer activities. These expenses are identified using project codes, with management costs allocated pro-rata to projects based upon project expenses. Any direct expenses (except occupancy) that are not project coded are distributed proportionately based on project coded wages and benefits within this category. Occupancy is allocated using square footage dedicated to a particular service.
- Shared expenses (primarily regional distribution center, central purchasing functions, and departmental staff) are regional in scope and support all five AOCs on a composite basis. These expenses are captured using either responsibility or project codes.
 - Regional distribution center (RDC) expenses are allocated to bill lines through project codes for employee-related expenses and by square footage for occupancy expenses.
 - Central purchasing expenses are allocated to specific bill lines through annual studies.